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# Breaking down the barriers: Competition, syndicate structure, and underwriting incentives ☆

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ABSTRACT

We argue that the entry of commercial banks into bond underwriting led to the evolution of co-led underwriting arrangements and lowered the screening incentives of underwriters. Lead underwriters in co-led syndicates faced weaker incentives to screen issuer quality. In boom markets, issues underwritten by co-led syndicates were more likely to be involved in financial misrepresentation events. Underwriter incentives in co-led syndicates were particularly weak in industries where commercial banks stole substantial market share. Similar patterns do not hold in bust markets where investors are likely to engage in their own information collection efforts. Our results suggest that competition may have an adverse effect on the incentives of financial intermediaries in market environments where their information production is more valuable to investors.
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## 1. Introduction

The removal of underwriting barriers erected by the Glass-Steagall Act heralded an era of intense competition in securities underwriting in the US as commercial banks entered a market traditionally dominated by investment banks. In the aftermath of the financial crisis, observers have questioned whether the entry of commercial banks into investment banking led to weaker lending standards, increased risk-taking behavior, and contributed to losses faced by the financial sector.[2]

The foray of commercial banks into securities underwriting has been the focus of much inquiry. Prior work shows that commercial banks eased capital market access for smaller and riskier issuers and lowered underwriting fees. The literature is relatively silent, however, on how this regulatory change affected the incentives of underwriters. In this paper, we study how the entry of commercial banks affected the incentives of underwriters to certify the quality of new bond issues. Prior to commercial bank entry, underwriting syndicates

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[2] See, for example, "The financial crisis: walls come down, reviving fears of a falling titan," Wall Street Journal, September 23, 2008.

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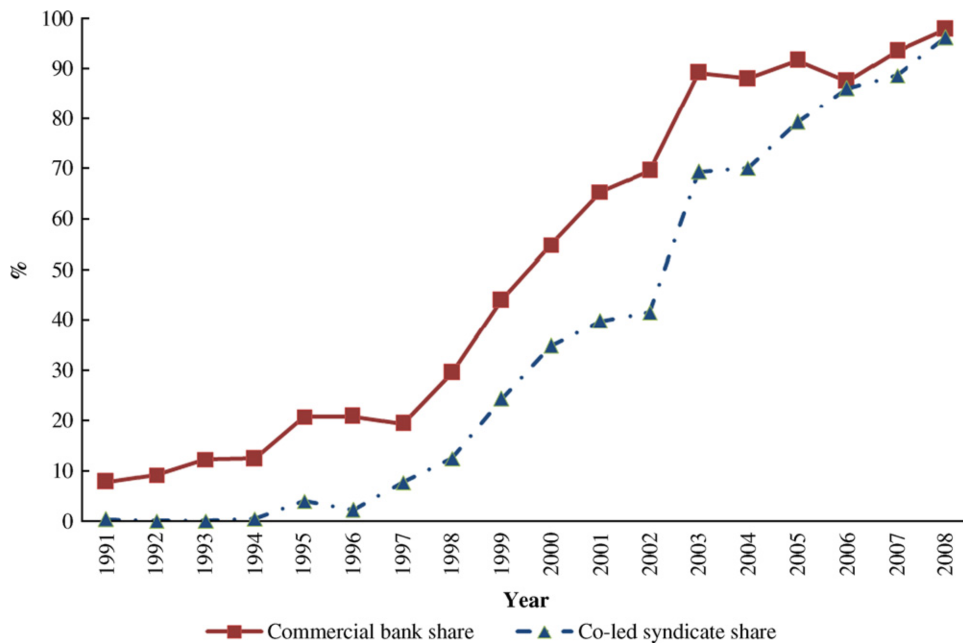


**Fig. 1.** Commercial bank entry and co-led syndicate share. The sample consists of 6370 bonds issued by nonfinancial firms during 1991–2008. Commercial bank underwriters are those with Section 20 subsidiaries. Co-led syndicates are syndicates led by more than one lead underwriter. Bank share is the yearly total number of bonds with at least one commercial bank serving as a lead underwriter as a percentage of the total number of bonds issued in the same year.

consisted of a lead underwriter and a group of co-managers. With the dissolution of Glass-Steagall barriers, commercial banks competed intensely for the lead underwriting spot, often relying on their lending relationships to win these mandates (Sufi, 2004; Yasuda, 2005; Ljungqvist, Marston, and Wilhelm, 2006). We show that issuers responded to this increased competition by including multiple institutions as lead underwriters, leading to the advent of the co-led syndicate structure.

Fig. 1 shows the trends that we study. Before 1994, investment banks dominated the bond underwriting business with the market share of commercial banks hovering at or below 10%. After 1995, commercial banks captured a significant portion of the market from investment banks, expanding their market share to almost 56% by the end of the 1990s, and to 94% by the end of 2008.[3] Contemporaneous with this expansion, we observe the emergence of co-led syndicate structures. While multiple lead underwriters were unheard of before 1995, co-led syndicates were present in almost a third of all bond issues by 2000, and in 96% of bond issues by 2008. Similar patterns of commercial bank entry and growth of co-led underwriting syndicates are also shown by Sufi (2004). This simultaneous growth in bank underwriting and co-led syndicates could reflect the use of bank credit by commercial banks to win the lucrative lead underwriting slot. Alternatively, as noted by Sufi (2004), it could reflect the issuer's desire to avoid an informational stronghold by a bank when it is both a lender and underwriter.

Our key question is whether the co-led syndicate structure affected the incentives of participating underwriters to screen the quality of new security issues. We argue that, in co-led syndicates, screening incentives are lowered due to a free-rider problem among underwriters. Reputational effects have long been recognized as being an important source of incentives for underwriters to screen issuer quality. However, as Tirole (1996) points out, when agents participate in a group, the group reputation spillover effect reduces the incentive of individuals in a group. Thus, we hypothesize that the emergence of co-led syndicates led to less screening by underwriters and lower quality issuers accessing the market. Of course, screening quality is not the only dimension by which sole- and co-led syndicates differ. Co-led syndicates potentially offer other advantages such as enhanced distribution and marketing services and may mitigate an informational stronghold by the bank over the company. Thus, syndicate structure will be endogenously determined by the tradeoff between weaker screening incentives and the potential advantages of having multiple lead underwriters.

Our measure of the quality of screening by underwriters is based on the incidence of securities fraud class-action lawsuit filings and earnings restatements that occur following a bond issue. Using these events as proxies for financial misconduct, we ask whether weaker screening by co-led syndicates enabled firms to misrepresent themselves as high quality issuers. Our primary evidence comes from 1996 to 2000, a period representing a substantial

[3] As described later, the expansion of commercial bank market share coincides with the relaxation of the 10% revenue limitation for commercial banks.

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